

The U.S. versus China: Can Policies Diverge for Long?

Investor opinions are just about evenly split on whether the Federal Reserve (Fed) will raise rates this year or not, but most believe the odds of a rate hike will grow if stocks continue to rally. The "chicken and egg" circularity between stocks and Fed policy has created much confusion among investors. There is little investor conviction in the sustainability of the ongoing rally in risk assets, as most investors expect the issue of Fed policy to resurface sooner rather than later.

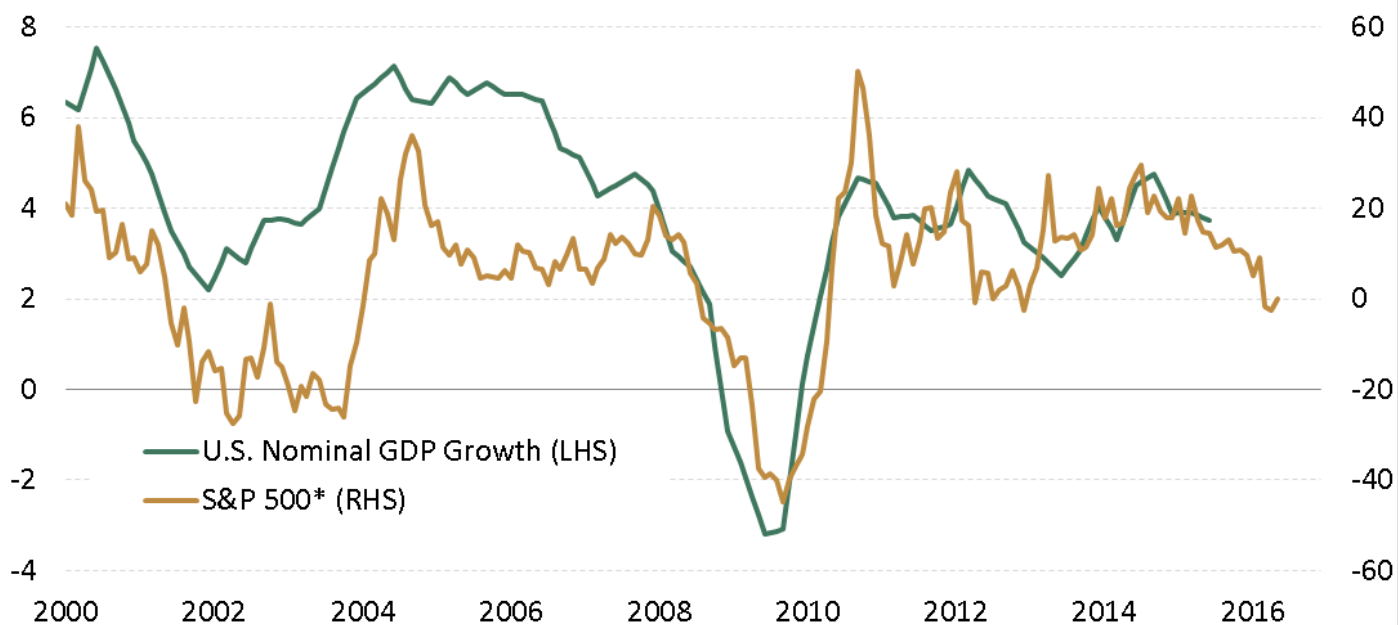
My take is that the U.S. stock market is happy with the weaker non-farm payroll data, because the market's reaction suggests the average investor's opinion is that any rate hike in today's environment would be premature. Furthermore, I am very skeptical that the Fed will normalize rates in the next several months because in recent past, the stock market has been more astute than the Fed in identifying the trend in the U.S. economy.

There have been three stock-market corrections that have exceeded 10% since 2009:

1. The summer of 2010 (-15%)
2. The summer of 2011 (-18.4%)
3. April/May of 2012 (-10%)

Each of these downdrafts in stock prices predicted a growth swoon and subsequent Fed action to prop up growth. The predictive nature of these market corrections is clearly illustrated in [Chart 1](#):

Chart 1: U.S. Nominal GDP Growth & S&P 500 Annual % Change; As of 10/7/15



**Advanced by 7 months
Source: Thomson Datastream*

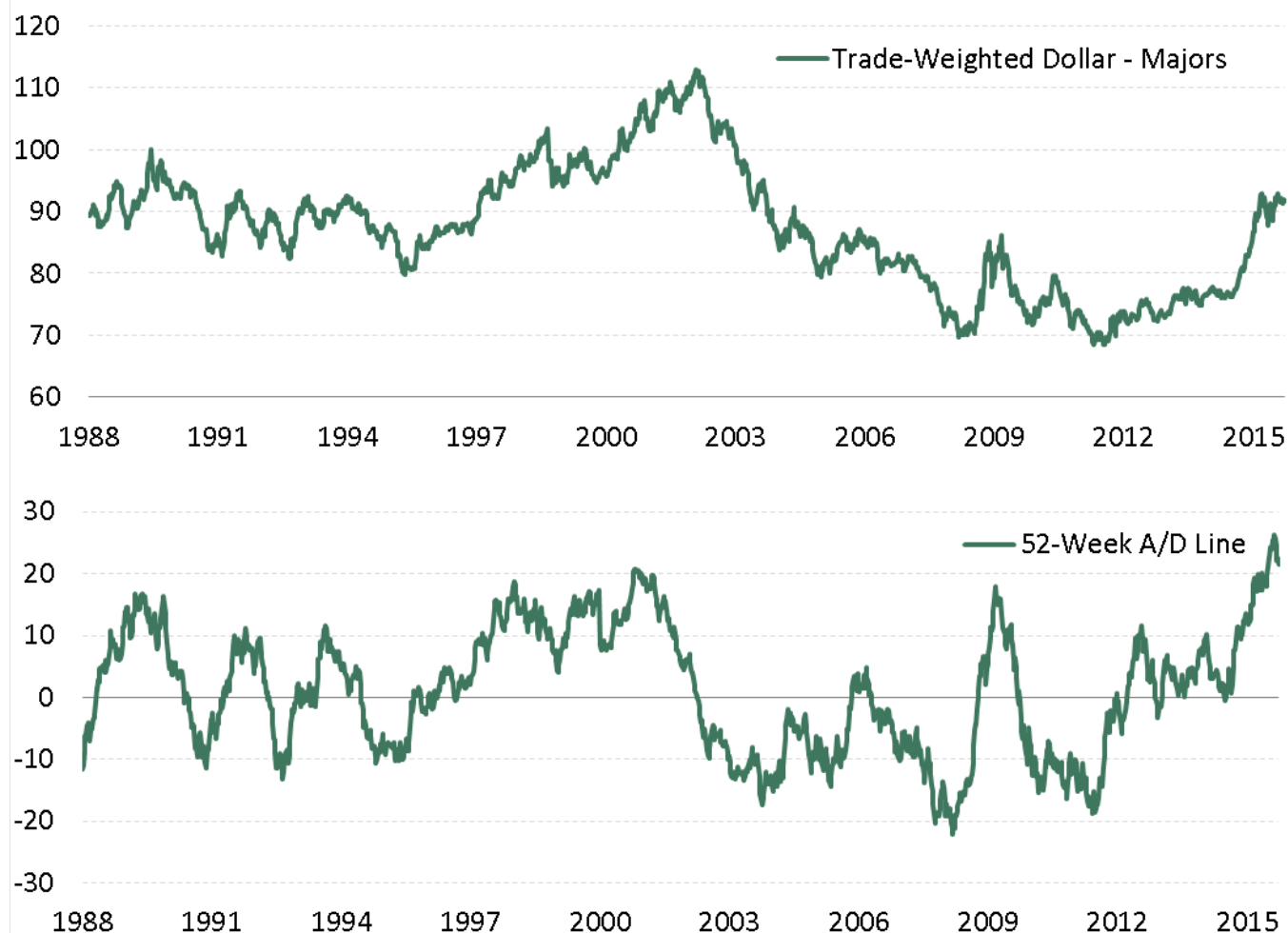
Judging by the magnitude of the recent stock market decline, weakness in the U.S. economy could be more prevalent than what members of the Federal Open Market Committee (FOMC) currently believe. The historical correlation between the stock market and the economy suggests that nominal gross domestic product (GDP) growth in the U.S. economy could slow to about 2.0-2.5%, a level that is low enough to prevent the FOMC from raising rates. Factors to blame for the U.S. economic slowdown include the financial turmoil in emerging markets (EM), the growth slowdown in China, the collapse in commodity prices and subsequent contraction in global mining and energy sectors, but a strong U.S. dollar is also a key factor in depressing nominal variables and siphoning off strength from the U.S. economy.

To put current conditions into proper perspective, the real trade-weighted dollar surged 34% in the second half of the 1990s, at a time when the U.S. economy was in a boom and real GDP growth exceeded 4%. This time around the dollar has gained more than 22% since 2011, but the U.S. economy has been growing at less than 2%.

In other words, the dollar has gained more than two-thirds of the strength it did in the second half of the 1990s with the economy only growing at half the speed. By characterizing low and falling inflation as being "transitory," the FOMC might have grossly underestimated the deflationary tendencies created by a strong dollar.

If a broad-based slowdown in the U.S. economy is indeed developing, the slowdown would force the Fed to delay any attempt at raising rates. In the event the U.S. is amidst an economic slowdown, the dollar may have already hit its highs against the major currencies back in March. [Chart 2](#) confirms the dollar bull run against the majors is very stretched.

Chart 2: Trade-Weighted Dollar – Majors & 52-Week A/D* Line As of 10/1/2015**



**A/D (advance/decline) line measures breadth of market*

***Based on EUR constituents prior to 1999*

Source: Thomson Datastream

However, it is still not certain whether the dollar has reached a broad top against EM currencies, as the risk in this case is the outlook of the Chinese economy.

Pessimism over China is probably at an extreme, which means prices might have over-discounted the reality. The issue with China today is not so much about whether the economy will experience a hard landing or not; instead it is about the speed of a policy shift and the potency of economic improvement.

Here are a few important points to share with readers:

- First, there is growing discontent with Premier Li amongst government bureaucracies. Some senior government officials are openly discrediting or even confronting Li's economic policy which is comprised of very tame stimulus programs and tepid plans to restructure the state sector. Worse still, our sources suggest there is no blueprint or consensus on how to reform the state monopolies, nor is there a clear plan on how to deal with the slackening economy.
- Second, the anti-corruption campaign has scared local government officials into inaction. In recent months there have been numerous stimulus programs announced by Beijing aimed at propping up growth, but these are not being carried out by local government officials because they are afraid of making any mistakes. In other words, the political system has become dysfunctional and a political/policy paralysis is hindering the effectiveness of economic policy.
- Third, even President Xi is under growing political pressures from both within and outside the

Communist Party of China as economic growth continues to drop. Businesses are loudly complaining about the poor economy, while the labor market is rapidly becoming too soft to absorb the growing work force. Within the party, more and more are questioning whether Xi has deviated too much from the long-held policy of "squarely focusing on growth." Therefore, China's economic and political agendas are in flux and some major shifts will likely take place soon.

The Fifth Plenary Session of the Central Committee will be held in mid-October, followed by the Central Economic Work Conference, which should lay out economic plans for 2016. I think this event is worth closely monitoring. A few things need to happen before we can call the turning point for the Chinese economy:

1. The fiscal deficit must sharply increase to stimulate public investment. So far Beijing remains very reluctant to do so and Premier Li still wants to limit the budget deficit even though deflation has become a prevalent problem. The Li Administration needs to launch a program like the Troubled Assets Relief Program (TARP) soon to boost growth.
2. The People's Bank of China needs to drop interest rates quickly to 2-3% from over 5-6% in order to bring the real lending rate—which still stands at 10-12%—in line with real GDP growth of 6-7%. Ideally, China should drop its currency too, but because President Xi promised no devaluation, it is unlikely that Beijing will allow much currency depreciation to happen in the near term. This means that China cannot relax its capital controls if rates are expected to fall.

The only remedy to overcome the drag from an overvalued yuan is aggressive fiscal stimulus. Any disappointment in fiscal spending could lead to increasing capital flight and worsening deflation as the currency tries to devalue itself in real terms.

Groupthink is bad, especially at investment management firms. Brandywine Global therefore takes special care to ensure our corporate culture and investment processes support the articulation of diverse viewpoints. This blog is no different. The opinions expressed by our bloggers may sometimes challenge active positioning within one or more of our strategies. Each blogger represents one market view amongst many expressed at Brandywine Global. Although individual opinions will differ, our investment process and macro outlook will remain driven by a team approach.

©2024 Brandywine Global Investment Management, LLC. All Rights Reserved.

Social Media Guidelines

Brandywine Global Investment Management, LLC ("Brandywine Global") is an investment adviser registered with the U.S. Securities and Exchange Commission ("SEC"). Brandywine Global may use Social Media sites to convey relevant information regarding portfolio manager insights, corporate information and other content.

Any content published or views expressed by Brandywine Global on any Social Media platform are for informational purposes only and subject to change based on market and economic conditions as well as other factors. They are not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. Additionally, any views expressed by Brandywine Global or its employees should not be construed as investment advice or a recommendation for any specific security or sector.

Brandywine Global will monitor its Social Media pages and any third-party content or comments posted on its Social Media pages. Brandywine Global reserves the right to delete any comment or post that it, in its sole discretion, deems inappropriate or prevent from posting any person who posts inappropriate or offensive content. Any opinions expressed by persons submitting comments don't necessarily represent the views of Brandywine Global. Brandywine Global is not affiliated with any of the Social Media sites it uses and is, therefore, not responsible for the content, terms of use or privacy or security policies of such sites. You are advised to review such terms and policies.